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Discussants' Response No. 1 to "Illegal Acts: What is The Auditor's Responsibility?"

Editor's Note: As mentioned in the preface, we have two discussants' responses for this paper. The first response represents the comments by three students from the accounting program at the University of Kansas. These students were selected as the 1990 Deloitte & Touche Symposium Fellows. The other response is the usual academician's remarks by Professor McNair, Mississippi State University. The two responses are given below in the order they were presented.

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Our objective in critiquing the paper by Mr. Guy, Mr. Whittington and Mr. Neebes is to find ways of improving SAS 54 [AICPA, 1988]. Our comments will deal with issues related not only to reducing ambiguities in the interpretation and implementation of the SAS by different auditing firms but also with expanding the scope of SAS 54 to other issues that have not been considered by the profession. Our discussion will be directed towards SAS 54 because much of the paper is a restatement of the SAS.

We will address the following issues in our paper:

- The distinction between direct and indirect illegal acts.
- The auditor's competence in detecting illegal acts.
- SAS 54's "if necessary" clause.
- Auditor's neutrality towards industry in detecting illegal acts.
- Qualitative materiality.
- Auditor's responsibility towards communicating audit findings.

The first issue is direct versus indirect illegal acts. In order to accomplish the objective of consistent application of the SAS, there needs to be a more clear distinction between direct and indirect illegal acts within the SAS. In the case of direct effect illegal acts, the auditor is responsible for designing the audit to provide reasonable assurance that the financial statement amounts are free from material misstatement resulting from such acts. However, in the case of indirect effect illegal acts, the auditor is responsible for the detection of such acts only when information comes to his or her attention concerning their possible existence. The last sentence of paragraph seven of SAS 54 more clearly states the auditor's responsibilities for indirect illegal acts:

“... an audit made in accordance with GAAS provides no assurance that illegal acts will be detected or that any contingent liabilities that may result will be disclosed.” Given this wide disparity in the treatment between direct and indirect illegal acts, it is crucial that the auditor is provided with a clearer distinction between these two types of illegal acts. What if the auditor did not detect any illegal acts and therefore, according to SAS 54, assumed that any illegal acts that actually existed were indirect in nature and not within the auditor’s responsibilities? Then, in retrospect, assume that a direct effect illegal act did occur. Since the auditor did not detect nor disclose this act, he or she would be liable to the users of the financial statements.

It is clear that the difference in responsibility for direct and indirect illegal acts is critical in determining the auditor’s liability. The paper and SAS 54 define direct and indirect illegal acts primarily by example. We contend that their use of only one example to describe indirect illegal acts, which is simplistic compared to the complexities that can and do arise in reality, is insufficient in leading auditors to consistent application of the standard. The example used in the paper is the same one that was used in SAS 54. To illustrate these complexities consider the following situation. A chemical manufacturer is operating at a gross margin of ten percent while other companies in the industry are operating at an average of five percent. Suppose that this higher gross margin is due to the fact that the company has failed to acquire the requisite environmental protection equipment. One could argue that the difference in the gross margin has a direct effect on the financial statements, while another could argue that the effect of the illegal act is indirect due to fines or other contingent liabilities that might arise due to the company’s failure to follow the requirements of the Environmental Protection Agency (EPA).

A second important issue relates to the auditor’s competence in detecting illegal acts. As the authors state in the paper, SAS 54 professes that auditors do not possess the legal training necessary to recognize all circumstances leading to litigation. Also, the SAS contends that the determination as to whether or not a particular act is illegal is generally based on the advice of an informed expert qualified to practice law. Given the auditor’s lack of legal expertise, SAS 54 directs the auditor towards management in the search for illegal acts. Further, the paper states that audit procedures rely heavily upon the cooperation of the client’s management. However, this heavy reliance on the client’s management provides only limited evidence of compliance with laws and regulations. And, while this limitation is discussed in the paper, no alternative audit procedures are provided. We believe that the paper should highlight procedures outside of receiving management representations, such as examining regulatory approval letters or political contributions.

The third issue we wish to discuss deals with the “if necessary” words that appear in paragraph twelve of SAS 54. We believe that SAS 54 is contradicting itself with this paragraph. It first disclaims the auditor’s competence in the area of illegal acts, and then directs the auditor towards management for information concerning any such acts. But in paragraph 12, the auditor’s responsibilities are increased by the “if necessary” language. This clause takes the responsibility off of the client, where it rightfully belongs, and instead al-

lows the client to force the auditor to decide the legality of the client's acts. The client should be the one who makes any decisions and arrives at any conclusions necessary in regards to alleged illegal acts. The auditor should only be required to act upon the decisions of management. It is our belief that the "if necessary" clause should be removed from the SAS 54 and that auditors should be required to consult with a legal counsel when any and all illegal acts are discovered.

We are also concerned about one of the paper's recommendations. The authors argue that the auditor's detection responsibility for illegal acts cannot be expanded because the auditor is not an expert in the area. This is quite true, but auditors are often forced to use outside experts in the conduct of an audit when they lack the necessary expertise. In fact, SAS No. 11, *Using the work of a specialist* [AICPA, 1975, and 1989], addresses this subject.

So why not require the use of lawyers as outside experts during an audit? We are not suggesting that lawyers work alongside auditors throughout the audit or be used on every audit. Instead, a lawyer could be required if the auditor is not satisfied after inquiry of management counsel (the "if necessary" point). At the very least, a reference should be made to SAS No. 11.

A fourth issue deserving of comment on deals with auditor's neutrality towards industry in detecting illegal acts. Seeing no discussion of this issue in the paper and SAS No. 54 implies that the auditor should maintain a neutral attitude across industries. It is our contention that auditors should have greater skepticism before beginning audits in certain industries where illegal acts may be prevalent. The defense, savings and loan, and securities industries are prime examples.

Our fifth concern about SAS No. 54 deals with the definition of qualitative materiality. This issue was not addressed in the paper. SAS No. 54 requires the auditor to evaluate both the quantitative and qualitative materiality of an illegal act that comes to his or her attention. Qualitative materiality is defined by example with a reference to SAS No. 47 [AICPA, 1983]: "an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue." We believe that such a definition is inadequate.

An illegal act could be "qualitatively material" even if its quantitative effect on the financial statements is not material now or even several periods later. The term "qualitatively material" suggests an illegal act that, if committed by top management or with the knowledge of top management, would affect the decision of a reasonable user of the financial statements. Examples of such illegal acts are: violations of securities laws, environmental laws, and bidding regulations for government contracts. By not adequately defining the term, SAS 54 may be allowing auditors not to require management disclosure of illegal acts which users would be genuinely concerned about. Illegal acts of this nature directly reflect the integrity of management.

Investors do actually care about more than merely the quantitative aspects of companies they invest in. The presence of "clean" mutual funds, which do not invest in companies with major ties to South Africa or companies with operations which harm the environment, is one indicator that investors are concerned about the qualitative aspects of companies they invest in.

We believe that qualitative materiality could be better defined. Of course, it is very difficult to define such an ideal standard which could be applied consistently across audits and among auditors. Any new definition would, of course, require future research. But a good definition of qualitative materiality as it applies to illegal acts might include the following points:

- The illegal act is a felony.
- A member of top management has been convicted of or charged with, or a member of top management knew of and could have prevented the act.
- Purely personal acts unrelated to the financial statements should be excluded.

In regards to our last issue that deals with auditor's responsibility towards communicating audit findings, the authors state:

One of the objectives of the expectation gap SAS's was to improve the communications to boards of directors and audit committees to help them fulfill their financial reporting and oversight responsibilities.

While we feel that SAS 54 does an adequate job improving communications between auditors and their clients, it falls short in the task of closing the expectation gap that exists between the public and the auditor in regards to the detection of illegal acts. Many people in the public incorrectly view an auditor as an expert on every matter relating to a client's financial statements. However, according to paragraph three of SAS 54, an auditor is "one who is proficient in accounting and auditing," not in the detection of illegal acts.

One way to close this expectation gap would be to modify the standard unqualified audit report to include an additional paragraph that deals with the client's system of internal control. Currently, the AICPA has formed a task force to examine this possibility. An internal control paragraph would serve two purposes. First, it would clearly communicate to users that *management is responsible* for establishing a system of internal control. The paragraph might also include the following items that the client's system is supposed to accomplish:

- Provide reliable data,
- Safeguard assets,
- Promote operational efficiency,
- Encourage adherence to proscribed management policies,
- Comply with the Foreign Corrupt Practices Act,
- *Prevent and detect* illegal acts.

In addition, the paragraph should state that management is responsible for the *design, installation, and effectiveness* of the company's internal control system as discussed in SAS 30. Also, the additional paragraph should include the auditor's opinion about how the client's internal control system is meeting the above objectives. According to the second standard of field work, the auditor is only required to obtain an "understanding" of the client's internal control system. In order for an auditor to express an opinion on the quality

of a client's internal control, more audit procedures may be required. The AICPA and auditing firms would be required to determine the appropriate amount of procedures that are necessary in order to issue an opinion. SAS 63 [AICPA, 1988] on auditing of governmental entities may be useful in designing any standard on the internal control reporting requirements for publicly traded firms. Auditors are required to report on the quality of a governmental entity's internal control structure.

While we believe that the modification of the standard audit report to include an opinion on the client's internal control would help close the expectation gap, it may not be necessary for all types of clients. For example, for a small, sole proprietorship with a small number of financial users the additional cost of evaluating their internal control system would probably be impractical. The additional procedures and fourth paragraph would be most appropriate for publicly traded companies with a large number of financial users.

In conclusion, a conversation that we had with Tom Bintinger, a partner with Deloitte & Touche and a member of the Auditing Standards Board at the time SAS 54 was adopted, summed up our reasons for suggesting a change in the standard audit report. He said that it would be far more constructive to establish preventive measures than to increase the auditor's detection responsibilities. After all, it would be better to stop illegal acts before they occur rather than simply discovering them after-the-fact.

References

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